UBS House View

Europe
Chief Investment Office WM

Weekly

27 October 2016

Deeper dive
Three, two, one
— p. 2

Regional view
Is Spain becoming the new Italy?
— p. 3

Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	–0.2%	–0.7%	6.5%
Euro Stoxx 50		–0.1%	2.8%	–2.3%
MSCI EM	OW	–0.3%	4.7%	17.3%
FTSE 100		–1.4%	3.8%	15.0%
SMI	UW	–2.8%	–4.5%	–7.8%
NIKKEI 225		0.6%	4.7%	–7.4%
US high grade bonds	UW	–0.3%	–0.5%	5.2%
Euro high grade bonds	UW	–0.6%	–0.9%	5.9%
US investment grade bonds	OW	–0.4%	–0.3%	8.7%
Euro investment grade bonds		–0.3%	–0.2%	5.5%
US high yield bonds		–0.1%	3.3%	14.7%
European high yield bonds		0.2%	2.3%	8.3%
EM sovereign bonds		0.2%	1.8%	14.1%
EM corporate bonds		0.2%	1.8%	12.3%

Source: Bloomberg, UBS as of 27 October 2016
OW = tactical overweight
UW = tactical underweight

Market comments
Calculations are based on the past five days

- **Equities** were subdued this week, with the US and European markets moving fractionally lower. The Swiss market was a big loser, down 2.8%.
- **Fixed income** markets were also weak, with Euro high grade bonds ceding 0.6% and US ones 0.3%. US investment grade bonds were off 0.4%.
- **Foreign exchange** trading pushed the dollar higher across the full range of G10 and emerging market currencies. The Brazilian real was the only major currency to hold its ground, ending the week flat.

In focus

The sound of silence. The European Central Bank (ECB) kept all of its policy measures unchanged, while highlighting that an abrupt end to quantitative easing (QE) is unlikely. The possibility of tapering or extending QE was not discussed. President Mario Draghi said the ECB will look through blips in the data, setting its focus squarely on the medium-term price stability target. *CIO expects the ECB to continue buying bonds at EUR 80bn or less from April on.*

Politics pushing down sentiment? US consumer confidence fell in October. The Conference Board measure slipped to 98.6 from 104.1 in September, falling short of consensus expectations for a 101.5 reading. A divisive US election, some suggest, is weighing on gauges of present conditions and future expectations. Still, a measure of job-market tightness is close to post-recession highs. And households are still sunny about their income prospects, supporting ongoing consumption growth. *CIO is overweight on US equities versus high grade debt in global portfolios.*

Stirring sterling. After Tuesday's losses against the US dollar, the pound recovered some poise on Wednesday, rallying above 1.22 against the greenback. GBP was bruised by comments from UK Chancellor Philip Hammond that easier QE was not out of the cards. Markets quickly moved from a Philip to a fillip, as Bank of England Governor Mark Carney told lawmakers that rate setters would not ignore the implications of a weaker pound on inflation and monetary policy. Sterling gained back some ground in response. *CIO expects near-term cable volatility, but thinks GBPUSD can rally to 1.36 in 12 months.*

Tokyo trade tops estimates. Japan's exports contracted 6.9% y/y in September, better than a 9.6% y/y decline in August and the estimated 10.8% y/y drop. Imports fell 16.3% y/y from a revised 17.2% y/y plunge in August, and surpassed the expected 17% y/y decrease. In seasonally adjusted terms, the trade balance remains in surplus but has started to narrow to JPY 349bn (from JPY 364bn). *CIO is neutral on Japanese equities in global portfolios.*

Outflows rise, but no EMergency. Increased chances of a Federal Reserve rate hike in December and rising global bond yields have taken some shine off emerging market (EM) local currency bonds. Outflows from the asset class hit USD 727m in the week to October 19, the largest exodus since the third week of January, according to fund flow follower EPFR. *Still, CIO is not spooked about the outlook for EM equities – stay overweight versus Swiss stocks, as EM economic and earnings data continue to improve.*

The strength of the Swiss. For those who feel a competitive currency is the key to export success, Switzerland has a message. The nation's trade surplus hit a record high in September, despite a 5% trade-weighted rise in the franc since January 2015 and a much longer period of strength. The pharmaceutical industry can claim much of the credit, offsetting weakness among watchmakers. Even so *CIO is underweight Swiss equities versus emerging market stocks – the defensive Swiss index is less likely to benefit from improving global growth.*

This report has been prepared by UBS AG, UBS Switzerland AG and UBS Financial Services Inc.
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Deeper dive

Three, two, one

Mark Haefele
Matthew Carter

Investing is a long-term endeavor. Yet asset prices move daily as markets identify key events, anticipate market triggers, and react when outcomes are known. Countdowns are an integral feature of global financial markets.

Since early October, investors have been counting down to when the European Central Bank (ECB) will decide on its quantitative policy. The primary question being posed is: will the ECB continue buying bonds at a pace of EUR 80bn a month beyond March or "taper" its asset purchases? President Mario Draghi offered no answers after the rate setters' October meeting. So which of the two options – taper or no taper – is most likely?

CIO's base case is that the ECB will start tapering next year. When quantitative easing (QE) began in January 2015, the euro area was in deflation (–0.6% y/y), and Brent oil prices were dragging down headline numbers. Fast forward to today, and inflation stands at 0.4%, while crude is 9% higher in euro terms than a year ago.

Fewer oil price headwinds suggest inflation will rise toward the central bank's price stability target by end 2018 or early 2019, according to Draghi. The ECB has an inflation target of "below, but close to 2%." Given the ECB's forward guidance, it makes sense to reduce monetary stimulus gradually as price pressures build, not when 2% is within touching distance.

What are the top three investment implications?

1. The euro should rise in response. Higher prices and a healthy current account surplus should boost the euro in trade-weighted terms, following a 7% decline last year. Less ECB accommodation and an external surplus underpin the EUR, while a weaker USD should reflect only a gradual Federal Reserve hike cycle and a widening external deficit. EURUSD can therefore rally toward 1.20 in 12 months.

2. Core government bonds like German Bunds are already pricing in decreased ECB liquidity, but yields may rise further. Ten-year yields have climbed around 20 basis points from post-Brexit lows to hover around 0%. We expect them to reach 0.3% in 12 months. This supports continued underweight positions on high grade debt in portfolios.

3. CIO is neutral on Eurozone stocks over our tactical six-month investment horizon. A stronger euro could reduce Eurozone firms' competitiveness abroad, and weigh on international earnings. On the flip side, greater growth may give firms a welcome increase in domestic sales. For now, these positive and negative effects look balanced.

Higher inflation and steeper yield curves globally may lead investors to rotate into leveraged, more value-oriented sectors. Our equity strategists recently upgraded global and US financial stocks to overweight, reflecting some possible easing of interest margin pressures on the back of higher US rates. Eurozone banks are still not a buy however, as the sector needs more loan growth, clarity on regulatory requirements, and further cost containment to justify current consensus earnings expectations.

Draghi hinted the ECB would announce its policy plans at its December meeting, which coincides with the release of new growth and inflation forecasts. If ECB staff members pare their forecasts, the taper debate may well be postponed further. But all else being equal, we identify three investment implications, two taper scenarios, and one base case outcome. Three, two, one…and countdown to December.

Mark Haefele
Global Chief Investment Officer
Wealth Management

Matthew Carter
Global Investment Office

Bottom line

Markets have recently started speculating that the ECB is poised to reduce or taper its bond-buying program. Eurozone inflation looks set to accelerate into next year as oil price headwinds fade. Tapering in 2017 is therefore CIO's base case. Investors should prepare for a stronger euro and rising bond yields. Selected equity sectors, especially US financials, can benefit as yields and inflation rise more generally, not just in the Eurozone.

Regional view

Is Spain becoming the new Italy?

Podcast
www.ubs.com/cio-podcast

Roberto Scholtes Ruiz
Head Investment Office Spain

Spain will avoid holding a third election within a year, as the Socialist Party has finally decided to abstain in the investiture vote on 29 October. This will allow the People's Party leader and caretaker prime minister to be re-elected and form a government, breaking a ten-month stalemate. But the political outlook is far from clear. The new minority government faces an uphill battle, and major structural reforms or fiscal tightening shouldn't be expected from what will likely be a short-lived legislature.

The political gridlock is similar to the recent situation in Italy, where a fragmented and sometimes inoperative parliament impeded timely structural reforms, let the public debt climb beyond 130% of GDP, and contributed to the decline of trend GDP growth to below 1%. Having a weak government is new to the forty-year-old Spanish democracy, but it is happening at a period of creeping economic slowdown, likely weaker external tailwinds, and increasing pressure from Brussels to rein in the budget deficit.

Spain and Italy share a long and intertwined history. In addition to their geographical proximity and numerous cultural similarities, both countries have comparable economic structures as well as social and demographic trends. Nevertheless, their economic performance has been astonishingly different in the last three decades. Italy's real GDP growth averaged only 1.0% over this period while the Spanish economy grew by 2.5% per year. Even in the aftermath of the Great Recession, which harmed Spain much more than Italy, the former has recovered at an annual rate of 2.5% since 2013, compared to the latter's 0.3%.

But from here on out, Spain's political, economic, and fiscal landscape could increasingly resemble Italy's. Depending on what direction Spain takes at the current crossroad (either reforming its economy and institutional framework or entering a period of legislative paralysis), its economic and fiscal outlook could be as poor as Italy's or remain somewhat brighter. In the worst-case scenario, in a matter of a few years, Spain's trend GDP growth could fall to below 1% while ballooning public debt would place a major burden on its economy.

> "Although Spain has dodged a short-term political risk, the country is not out of the woods yet."

In conclusion, although Spain has dodged a short-term political risk, the country is not out of the woods yet. The economy will inevitably slow down to a meager pace, while public finances are still not yet on a sustainable path and the political and institutional system is quite dysfunctional. In many ways, Spain seems to be converging toward Italy and the next global downturn may cast doubts on its solvency. In the meantime, Italy is trying to reform its political system to streamline the legislative process to expedite structural reforms.

Kind regards,
Roberto Scholtes Ruiz

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